

Message Text

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ACTION EUR-12

INFO OCT-01 EA-10 ISO-00 AID-05 CIAE-00 COME-00 EB-08
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SIL-01 OMB-01 SS-15 STR-07 CEA-01 SSO-00 INRE-00
NSCE-00 ICAE-00 DOE-15 SOE-02 DOEE-00 /102 W
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FM AMEMBASSY ROME
TO SECSTATE WASHDC IMMEDIATE 3577
TREAS DEPT WASHDC IMMEDIATE
INFO AMEMBASSY BERN
AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMCONSUL FLORENCE
AMEMBASSY THE HAGUE
AMCONSUL GENOA
AMEMBASSY LONDON
AMCONSUL MILAN
AMCONSUL NAPLES
USMISSION NATO
AMEMBASSY OTTAWA
AMCONSUL PALERMO
AMEMBASSY PARIS
AMEMBASSY STOCKHOLM
AMEMBASSY TOKYO
AMCONSUL TRIESTE
AMCONSUL TURIN

C O N F I D E N T I A L SECTION 1 OF 2 ROME 11110

USOECN ALSO FOR EMBASSY: USEEC ALSO FOR EMBASSY

EO 11652: GDS
TAGS: EFIN, IT
SUBJ: ECONOMIC PROSPECTS FOR 1978 AND 1979

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REF: (A) ROME 1514, (B) ROME 5839, (C) ROME 6365

1. SUMMARY? THE LACK OF PROGRESS TO DATE IN REDUCING THE
PUBLIC SECTOR DEFICIT IS A MAJOR REASON FOR REVISING OUR
PREVIOUS 1978 FORECAST FOR THE ITALIAN ECONOMY (REFTEL C). WHEREAS
WE HAD PREVIOUSLY ASSUMED (REFTEL A) THAT THE ENLARGED
PUBLIC SECTOR DEFICIT WOULD BE KEPT TO 24,000 BILLION LIRE

(WHICH IN RELATION TO GDP WOULD HAVE BEEN THE SAME AS LAST YEAR), IT NOW APPEARS THAT THE OUTTURN MAY WELL BE ABOUT 27,000 BILLION LIRE. FURTHERMORE, RESULTS FOR THE FIRST QUARTER SHOW THAT THE FINANCING OF THIS DEFICIT IS LIKELY TO BE MORE INFLATIONARY THAN IT WAS IN 1977, WHICH CHANGES ANOTHER OF OUR PREVIOUS ASSUMPTIONS. OUR LATEST FORECAST FOR 1978 IS AS FOLLOWS: GDP GROWTH (REAL TERMS) 2.9 PERCENT, INFLATION 14.5 PERCENT, TRADE ACCOUNT SURPLUS \$625 MILLION AND CURRENT ACCOUNT SURPLUS \$2.8 BILLION. WITH RESPECTS TO 1979, WE ARE ASSUMING THAT THE GOVERNMENT WILL TAKE ACTION TO REDUCE GOVERNMENT EXPENDITURES AND KEEP THE SIZE OF THE PUBLIC SECTOR DEFICIT WITHIN "ACCEPTABLE" LIMITS. WE ARE ALSO ASSUMING THAT WAGE NEGOTIATIONS THIS FALL WILL KEEP WAGE INCREASES IN 1979 CLOSE TO THE RATE OF INFLATION PLUS PRODUCTIVITY GROWTH. IN OTHER WORDS, WE ARE WORKING UNDER THE ASSUMPTION THAT THE STABILIZATION EFFORTS BEGUN IN LATE 1976/EARLY 1977 WILL BE THE BASIS OF ECONOMIC POLICY FOR THE NEXT YEAR AND THAT PROGRESS WILL BE MADE DURING THE NEXT SIX MONTHS IN REDUCING BOTH THE PUBLIC SECTOR DEFICIT AND LABOR COSTS. WITH SOME SUCCESS ON THESE FRONTS, WE SHOULD BEGIN TO SEE IN 1979 A PICK-UP IN TOTAL INVESTMENTS. THIS IS A KEY PREMISE UNDERLYING OUR 1979 FORECAST. END SUMMARY.

2. POLICY FRAME WORK AND ASSUMPTIONS:

A. ENLARGE PUBLIC SECTOR DEFICIT OF 27,000 BILLION
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LIRE, WHICH MAKES FISCAL POLICY MORE EXPANSIONARY THAN LAST YEAR. IN ADDITION, UNLIKE THE SITUATION OF 1977 WHEN THE TREASURY DESTROYED MONETARY BASE, IN 1978 THE FINANCING OF THE DEFICIT IS EXPECTED TO BE A MAJOR CAUSE OF MONETARY BASE CREATION. FOR 1979, FISCAL POLICY SHOULD BECOME TIGHTER.

B. DOMESTIC CREDIT EXPANSION IN 1978 OF 44,000 BILLION LIRE, WITH LITTLE CHANGE FROM THE PRESENT LEVEL IN INTEREST RATES;

C. RELATIVELY STABLE LIRA-DOLLAR EXCHANGE RATE IN 1978 AND AVERAGE DEPRECIATION IN 1979 OF AROUND 5 PERCENT;

D. FURTHER SHIFT IN DOLLAR TERMS OF TRADE IN ITALY'S FAVOR;

E. WAGE NEGOTIATIONS THIS FALL WILL LEAD TO REAL WAGE INCREASES IN 1979 CLOSE TO PROJECTED PRODUCTIVITY INCREASE. LABOR UNIONS SEEM TO HAVE REALIZED THAT THE PORTION OF NATIONAL INCOME GOING TO DEPENDENT WORKERS SINCE 1969 HAS PROBABLY GONE FAR ENOUGH (IF NOT TOO FAR) --IT WENT FROM 67.6 PERCENT IN 1969 TO 73.0 PERCENT IN 1976--AND MAY THUS MODERATE THEIR WAGE DEMANDS DURING THIS FALL'S CONTRACT NEGOTIATIONS. THE GOVERNMENT IS NOW PREPARING WHITE PAPER ON LABOR COSTS WHICH IS SUPPOSED

TO SET OUT A PLAN ON HOW TO ACHIEVE THE TARGET OF
MAINTAINING INCREASES IN LABOR COSTS IN ITALY IN LINE
WITH THE REST OF THE EC. (IN 1977, PER UNIT LABOR COST
IN ITALY GREW THREE TIMES AS FAST AS THE OECD AVERAGE.)
FOLLOWING THE RECENT DECISION TO MAKE PERMANENT THE
FISCALIZATION OF CERTAIN SOCIAL BENEFITS, WE MAY SEE
THE GOVERNMENT MAKING FURTHER USE OF THE TAX SYSTEM TO
ACHIEVE THIS GOAL.

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C O N F I D E N T I A L SECTION 2 OF 2 ROME 11110

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3. FORECAST FOR THE ITALIAN ECONOMY FOR 1978 AND FIRST

HALF 1979.

1978 FIRST HALF 1979
OVER OVER

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	1977	FIRST HALF 1978
GDP	2.9	3.5
PRIVATE CONSUMPTION	2.4	1.9
PUBLIC COMSUMPTION	3.4	3.1
INVESTMENT	0.5	3.3
CONSTRUCTION	(1.6)	(3.4)
PLANT AND EQUIPMENT	(-.9)	(3.2)
EXPORT (VOLUME)	5.1	5.4
IMPORTS (VOLUME)	5.8	6.9
INFLATION (COST OF LIVING, AVERAGE)	14.5	12.0
UNEMPLOYMENT RATE	7.3	7.3

4. ECONOMIC GROWTH. THE BEHAVIOR OF INDUSTRIAL PRODUCTION DURING THE FIRST FOUR MONTHS OF THE YEAR (UP 4.2 PERCENT) CLEARLY REVEALS THAT THE ECONOMY IS ON THE UPWARD PHASE OF THE CYCLE. THE DROP IN THE SEASONALLY-ADJUSTED INDUSTRIAL PRODUCTION INDEX IN APRIL (OVER MARCH), HOWEVER, INDICATES THAT THE RECOVERY IS STILL "SOFT." WE ANTICIPATE A STRONGER PERFORMANCE IN SECOND HALF, WITH A SLIGHT DECELERATION IN THE FIRST HALF OF 1979.

5. CONSUMPTION. PRIVATE CONSUMPTION IS FORECAST TO BE VERY BUOYANT IN 1978. IT HAS BEEN BOOSTED BY (A) INCREASED PENSION PAYMENTS AT THE BEGINNING OF THE YEAR, (B) THE UNBLOCKING OF THE WAGE ESCALATOR FOR HIGH INCOME GROUPS ON MAY 1, AND (C) FURTHER GAINS IN REAL WAGES. FOR 1979 WE ARE ASSUMING A PICKUP OF INVESTMENT AND A DROPPING OFF IN THE RATE OF INCREASE IN PRIVATE CONSUMPTION.

6. INVESTMENT. INVESTMENTS SHOULD BEGIN TO PICK UP TOWARD THE END OF 1978 AS THE GOVERNMENT BEGINS TO

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IMPLEMENT PORTIONS OF THE NEW INDUSTRIAL RECONVERSION LEGISLATION. IN ADDITION, THE GOVERNMENT HAS ALLOCATED ADDITIONAL FUNDS FOR HOSPITAL CONSTRUCTION AND FOR THE MODERNIZATION OF THE RAILWAYS, WHICH SHOULD HELP THE CONSTRUCTION INDUSTRY AND INVESTMENT IN MACHINERY AND EQUIPMENT. ALTHOUGH EXCESS CAPACITY IS STILL SIZEABLE

IN THE ECONOMY, THE IMPLEMENTATION OF THE GOVERNMENT'S INVESTMENT PROGRAMS, TOGETHER WITH MODEST WAGE SETTLEMENTS THIS FALL (IF REALIZED) SHOULD HAVE A SPILL-OVER EFFECT IN PRIVATE INVESTMENT IN 1979. FINANCING SHOULD NOT BE A PROBLEM IF, IN FACT, PROGRESS IS MADE IN REDUCING THE SIZE OF THE PUBLIC SECTOR DEFICIT.

7. STOCKS. STOCK ADJUSTMENT IS A SIGNIFICANT VARIABLE IN ITALY FOR BOTH BUSINESS CYCLE TRENDS AND BALANCE OF PAYMENTS SWINGS. MONETARY POLICY THIS YEAR IS DESIGNED IN GREAT PART TO PREVENT AN EXCESSIVE INVENTORY BUILD-UP WHICH WOULD HAVE ADVERSE CONSEQUENCES ON THE TRADE ACCOUNT, EXCHANGE RATE AND INFLATION. ALTHOUGH THERE ARE NO HARD FIGURES ON STOCK LEVELS, OPINION SURVEYS DONE BY ISCO INDICATE THAT THE LEVEL OF STOCKS OF FINISHED PRODUCTS IS PRESENTLY SOEWHAT ABOVE NORMAL AND THAT OF IMPORTED RAW MATERIALS BELOW. WE ARE THEREFORE ANTICIPATING SOME BUILD-UP OF STOCKS OF IMPORTED RAW MATERIALS AND A DECLINE IN STOCKS OF FINISHED PRODUCTS IN THE SECOND HALF OF 1978 IN LINE WITH OUR EXPECTATIONS ABOUT CONSUMPTION AND INDUSTRIAL ACTIVITY. STOCK ACCUMULATION WILL ALSO BE INFLUENCED BY EXCHANGE RATE AND INFLATIONARY EXPECTATIONS. IF BY THE FALL THE GOVERNMENT FAILS TO PRESENT AN EFFECTIVE PACKAGE TO CONTAIN THE PUBLIC SECTOR DEFICIT, THUS INCREASING INFLATIONARY EXPECTATIONS, THERE MAY BE SOME ANTICIPATORY STOCK BUILDING IN ADDITION TO THE BUILD-UP RELATED TO INCREASED INDUSTRIAL ACITIVITY.

8. BALANCE OF PAYMENTS FORECAST FOR 1978 AND 1979.
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(MILLIONS OF DOLLARS))

	1977R	1978F	1979F
EXPORTS, F.O.B.	44,547	51,510	26,526
IMPORTS, F.O.B.	44,408	50,885	26,361
TRADE BALANCE	139	625	165
SERVICES	1,916	1,845	750
TRANSFERS	228	330	150
CURRENT BALANCE	2,284	2,800	1,065

R- REVISED FINAL DATA
F - FORECAST

9. CURRENT ACCOUNT. THE SOMEWHAT LARGER CURRENT SURPLUS PROJECTED FOR 1978, \$2.8 BILLION, AS COMPARED TO \$2.3 BILLION IN 1977, IS ATTRIBUTED ENTIRELY TO THE INCREASED SURPLUS ON TRADE, NOTWITHSTANDING THE PROJECTED PICKUP IN IMPORTS AND SLOWDOWN IN EXPORTS. ALTHOUGH REPORTED TRADE DATA THROUGH MARCH SHOW BOTH EXPORTS AND IMPORTS SUBSTANTIALLY BELOW PROJECTED LEVELS FOR 1978, THE UNDER-

LYING ASSUMPTIONS ON DEVELOPMENTS IN REAL TERMS FOR THE
YEAR ARE NOT CHANGED FROM THOSE SET FORTH IN REFTEL B.
WE BELIEVE THAT FIRST QUARTER TRADE DATA AS REPORTED BY
ISTAT MAY SUBSTANTIALLY UNDERSTATE ACTUAL RESULTS
BECAUSE OF STRIKES AT THE CENTRAL STATISTICAL INSTITUTE.
THE BALANCE ON TRADE AND CURRENT ACCOUNT ARE LIKELY TO
REMAIN IN SURPLUS THROUGH THE FIRST HALF OF 1979, IN
SPITE OF A FURTHER ACCELERATION IN PORTS OF 7 PERCENT
AS COMPARED TO RELATIVELY STABLE EXPORTS AT A 5.4 RATE.HOLMES

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